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ABSTRACT

Designed for high school economics students as a public service project of the American Fletcher National Bank, the booklet examines the "supply-side" philosophy of economics of the Reagan Administration as compared to the "demand-side" emphasis of the past. The manipulation of the nation's economy by raising or lowering government spending may be compared to the turning off and on of a water faucet. The Keynesian theory, which has prevailed since the Roosevelt administration, contends that deficit government spending can stimulate an economy by putting people back to work and creating a demand for new products, thus generating more production and jobs. Due to the tripling of the nation's debt in the 1970's, leading "supply-side" spokesmen under the Reagan Administration have developed the philosophy which attempts to maximize both productivity and government revenues by cutting federal taxes and eliminating unnecessary government spending. This in turn is thought to generate more business activity and productivity. With the exception of prior commitments (interest on the federal debt, government pensions, social security), federal expenditures must be trimmed sharply to offset the expected short-term loss in revenue. Although Americans are among the most lavish spenders and meager savers in the world, taxpayers must save or invest the money they retain from lower tax rates in order for supply-side economics to succeed. (LH)

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A RISING TIDE LIFTS ALL BOATS: AMERICAN'S NEW TEST OF 'SUPPLY SIDE' ECONOMICS

FUNDAMENTALS OF FREE ENTERPRISE
No. 7

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PROLOGUE

A Rising Tide Lifts All Boats *is the seventh booklet in the "Fundamentals of Free Enterprise" series produced by American Fletcher National Bank.*

A public service project of the bank, the series is designed primarily for high school students. It is distributed free to Marion County high schools—and at cost to other organizations desiring copies.

The booklets seek to interpret some of the economic principles which have enabled America to achieve world greatness. They also analyze timely economic issues which should be of interest to every American.

The "Fundamentals of Free Enterprise" series is a continuing project of American Fletcher. We invite your comments and suggestions about the series and how it can be more helpful.

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There have been 49 Presidential elections in the more than 200-year history of the United States, but historians generally agree that only a handful can be described as true watershed events.

Only a few elections have shown such major shifts in public opinion as to usher out one long-dominant political philosophy and replace it with something radically new.

In the 20th century, for example, the election of 1932 was one such milestone. The landslide which propelled Franklin D. Roosevelt into the White House brought with it bold and wide-sweeping changes in the relationship between citizens and their government.

A people deeply mired in the Great Depression cast aside their traditional belief in limited government. Certain that private sector business and industry had failed them, Americans were

ready in 1932 to hand over all their troubles to Washington. It marked the triumph of a liberal political ideology that has dominated federal policies for five decades.

Fifty years and a dozen Presidential elections later, it is possible that Americans have made another epoch-making turn with the election of 1980. In choosing conservative Ronald Reagan over an incumbent President with more conventional economic views, Americans perhaps have expressed mounting disenchantment with federal economic programs that have not checked inflation nor generated real growth in the Gross National Product.

The qualifying word perhaps is important; the significance of the election of 1980 is yet to be measured by long-term historical analysis. But in overwhelmingly endorsing a man who had pledged in his campaign to dismantle large components

of the federal establishment, Americans certainly have laid the groundwork for a prolonged political evolution away from the policies and programs of the last fifty years.

Among the profound charges President Reagan has brought to the executive branch is a radically different perspective on government's role in the economy. He has elevated the status of something called "supply-side" economics to the level of official government policy. It stands in stark contrast to the "demand-side" emphasis that has prevailed for half a century.

However, old ideas die hard, and what some have called an untested economic philosophy may be resisted or moderated by a skeptical Congress throughout the President's tenure in office. But if the President gets his way, and if his program works, it will mean that the fifty-year influence of an

obscure British economist has finally come to an end.

John Maynard Keynes is not a household word in most American homes, but no one has escaped the influence of this English intellectual who died in 1946.

Keynes' views have dominated Washington economic policy for two generations, regardless of the party in power.

Keynes reached his zenith in the 1930s, when the world was torn by depression and rampant unemployment. Keynes contended that deficit government spending could stimulate an economy out of a slump. By putting people back to work and providing them with disposable income, Keynes theorized that demand for new products and services could be spurred, which, in turn, would generate more production and more jobs.

The Keynesian theory was imaginative—and it worked. It became the cornerstone of Roosevelt's New Deal that started the nation's mighty industrial engine moving again. (Of course, the outbreak of World War II, bringing with it demands for unprecedented industrial production, helped, too.)

Over the years, the Keynesian concept became the prevailing philosophy in academic and political circles—and even won over a few skeptical business leaders who had been wary about this new government involvement in the workings of the marketplace.

The Keynesian approach became the solution to every lull in the nation's economy. By raising or lowering government spending and taxes, as well as injecting new dollars into the economy, the government could manipulate the nation's economy like a water faucet. When demand would become

sluggish, leading to slower production and unemployment, Washington could turn up the "pressure" and convert the trickle into a steady stream.

Conversely, when the economy would become too "hot"—when too much money was chasing too few goods, resulting in soaring prices—Washington could reduce demand by raising taxes and cutting back federal spending.

In essence, the Keynesian Revolution popularized the use of taxation, government spending, and the money supply to regulate the "demand side" of the supply-and-demand equation.

The triumph was so complete that by the end of the 1960s even a conservative Republican, President Nixon, could boldly proclaim, "We're all Keynesians now."

But the Keynesian system was not foolproof, and when Americans began to take stock in the 1970s, a growing

number disliked what they saw. They slowly awakened to the fact that much of their prosperity had been artifically stimulated by ever-larger federal expenditures—spending so huge that even steadily-rising tax rates couldn't keep pace. When tax revenues fell short of public spending, the government made up the difference by borrowing excessively and printing more money, thus cheapening the value of dollars already in circulation.

During all ten years of the decade of the '70s, the government ran up huge deficits.

The decade opened with the federal government spending at the rate of $196 billion a year; by 1980 it had reached a staggering $600 billion. Meanwhile, the nation's gross public debt had nearly tripled from $382 billion in 1970 to $905 billion in 1980.

The net effect of all this deficit spending was a steady increase in inflation, with the annual percentage increase in the Consumer Price Index often reaching the double-digit level.

By the end of the decade, Americans considered inflation to be the No. 1 domestic problem, and there was increased skepticism that it could be brought under control.

Throughout the 1980 campaign, candidate Reagan proposed to the American people a new way out of the dilemma—a method that did not involve tampering with demand. Reagan said he could slow down inflation by cutting back taxes, paring the federal budget, eliminating non-essential regulatory costs and encouraging increased supply instead. Where did he get this seemingly new idea?

At the risk of oversimplifying a complex story, suffice it to say that during the late 1970s Reagan and his aides came under the

influence of a California economist named Arthur B. Laffer—mostly through the intercession of two of Laffer's friends, journalist Jude Wanniski and New York Congressman Jack Kemp.

These three—with Laffer the chief theorist—have become the leading spokesmen for "supply-side" economics. While Wanniski and Kemp have popularized his theories through their writing and speaking, Laffer has been the academic tutor—perhaps the long-term successor to Keynes as the single-most important influence on the nation's economic policies.

Laffer is widely known as the developer of the "Laffer Curve," a simple geometric device with wide-ranging implications.

At the root of the theory is Laffer's contention: "There are always two tax rates that yield the same revenues." At the top tax rate of 100%, production grinds to a halt because people simply will not work if the fruits of their labor are taken entirely by the government. At the other end of the spectrum, if the tax rate is zero, people will work enthusiastically, but there will be no government revenue, hence no government.

Somewhere between these two poles, says Laffer, there are two tax rates that will produce the same revenue. In the upper range, there is a point that will generate high public revenue without completely destroying initiative and productivity. In the lower range of tax rates, there also is a tax rate that will sustain high productivity

while yielding just enough tax revenue to equal what the government needs.

The trick, according to Laffer, is to find a third point between those two rates that will maximize both productivity and government revenues.

It is comparable, for example, to the decision the auto manufacturer must make—to sell a few cars for $100,000 each or a larger number for $5,000 each. Either way, the revenue could be the same. Somewhere in between, however, lies a price that will attract the largest number of buyers while allowing for production of a larger number of cars.

Unlike the commercial market and its pricing mechanism, however, the government has a monopoly on taxing power. Thus, government alone must pursue the lowest tax rate that will generate the maximum in both revenues and private sector productivity.

Applying this theory to the current situation, President Reagan and his advisers have concluded that America's high tax rates have been a major contributor to declining productivity and sluggish investment. What's the point of trying to make more money, his counselors ask, if government is simply going to take most of it?

Thus, the Reagan program for renewing the country's economic vigor is to ease tax rates downward, to eliminate all unnecessary government spending and to reduce regulatory costs. His "supply-side" advisers contend this will stimulate savings and investment, will subsidize the modernizing of the nation's rundown manufacturing facilities, and will create new jobs. Prices will stabilize, the administration says, because the output of America's factories will increase. The greater abundance of goods will hold price increases in check.

Seasoned observers of the national economic scene are quick to point out that "supply-side" economics really isn't new at all; it's just that the approach hasn't been used for so long that only a handful remain who can remember how it works. (Actually, it can be traced back to an 18th century French economist named Jean Baptiste Say.)

Some call it a return to the classic economic theories of the 19th century when market forces determined the price of goods and services, and government did little to interfere with the workings of the system. Taxes were kept at a minimum, while entrepreneurs—motivated by the possibility of healthy profits—pumped up economic activity with heavy investments for business expansion. The benefits of this profit-inspired activity "trickled down" to the masses in the form of increased employment and higher

wages based on gains in productivity.

According to Laffer, the most dramatic illustration of "supply-side" economics came in the 1920s, shortly after the United States had emerged from World War I.

It was during this period that Secretary of the Treasury Andrew Mellon persuaded President Warren Harding, and later Calvin Coolidge, to roll back high wartime tax rates. The excess profits tax on industry was eliminated, and the highest personal income tax rate of 77% was eased down to 25%.

The result was an eight-year explosion in economic growth. From 1921 to 1929, the Gross National Product went from $69.9 billion to $103.1 billion, and the national debt was reduced from $24.3 billion to $16.9 billion. The era of growth ended abruptly when President Herbert Hoover abandoned the policies of Mellon.

Another brief experience with "supply-side" tax policies came during the administration of President John F. Kennedy, whom Laffer describes as the nation's last "pro-growth" President before Reagan. Kennedy set a tax reduction program in motion in 1962, a year before his assassination. Kennedy's rationale was that reducing taxes "sets off a process that can bring gains for everyone . . . and is the best way open to us to increase revenues."

According to Laffer, Kennedy was constantly remarking that the best form of welfare is a good, high-paying job. He summarized his philosophy, that a growing economy elevates the standard of living for the poor and the affluent, with the phrase:

"A rising tide lifts all boats."
—JOHN F. KENNEDY

From 1962 through 1965, tax rates were adjusted downward. Tax revenues, however, climbed from $99.6 billion to $130.8 billion, and the gross national debt—despite high spending for varied social programs—rose less than $6 billion a year over the period. Meanwhile, the Gross National Product grew from some $500 billion to more than $700 billion in a period when the inflation rate was averaging less than 2% a year.

Laffer also contends that "supply-side" economics was responsibile for the post-World War II recovery of West Germany—a feat many describe as the economic miracle of the century.

Laffer credits the tax policies of Finance Minister Ludwig Erhard—not the Marshall Plan—for generating enough economic stability in West Germany to resist Communist encroachment.

As late as 1948, Germans

were paying a 50% tax rate on annual incomes of only $600 and a 95% rate on incomes above $15,000. Erhard steadily dropped those rates over the next six years. The result was a steady increase in national income—and enough tax revenue to construct the country's vast social programs and its powerful national industrial base.

Thus, there is some precedent for Laffer's contention that cutting federal tax rates will generate more business activity and more productivity, hence more corporate profits and income to tax. He also believes it will produce more honesty in reporting income on tax returns. The net result, according to Laffer, is that there probably will be no real loss in federal revenues in the long run and that many government-financed activities can continue unabated.

Skeptics have reservations about this optimistic picture. They fear that the United States, even with reduced tax rates, could continue on an inflationary binge if several other things don't happen—(1) if federal expenditures aren't trimmed sharply to offset the expected short-term loss in tax revenue; (2) if taxpayers don't save or invest the money they retain from lower tax rates; or (3) if Americans don't remain patient while waiting for the program to produce the expected results.

Reducing the federal budget is considered absolutely essential by most observers—but it isn't easy to do. President Reagan has proposed cuts of $44 billion in the 1982 budget, but the government still will spend $695 billion, about $50 billion more than in 1981.

The administration is discovering that some three-fourths of the budget, about $540 billion, is uncontrollable.

Some items—such as interest on the federal debt ($68 billion), government pensions ($45 billion), Social Security benefits ($155 billion), for example—are prior commitments that can't be abandoned.

Adding another $120 billion for defense spending, which few want to cut, produces a huge federal budget with little fat to trim.

If expenditures exceed tax revenues, the government has only two options to make up the deficit—and both are inflationary.

As the late columnist Walter Lippmann noted many years ago:

> *"In one way or another the budget is in fact always balanced. The true nature of the reckoning would be clearer if, instead of talking about an 'unbalanced' budget, we spoke of a budget balanced not by taxes but by borrowing, of a budget balanced by inflation, or of a budget balanced by subsidy."*

Deficit spending could force the government to borrow more money in the open market, thus crowding out many private individuals or businesses who want to borrow, too. Or the Federal Reserve could be persuaded to circulate more "cheap" dollars, which would add to inflationary pressures.

Skeptics also are concerned that the American taxpayer won't react in the desired manner with his extra cash. Savings and investment are important pillars in the "supply-side" theory, but

what if the taxpayer chooses to spend the extra money on consumer goods? This, say the critics, would stimulate demand and would result in more inflation because it would still be "too much money chasing too few goods."

There is ample reason for this fear.

Americans in recent years have become lavish spenders, and their savings rate of less than five cents of every after-tax dollar is among the lowest in the world.

Another factor which could inhibit the effectiveness of "supply-side" economics would be impulsiveness and impatience by the American electorate.

Even the most optimistic forecasts indicate that application of the theory cannot begin to produce results until 1983. By that time, supporters say, increased productivity should generate larger tax revenues, should increase supplies of goods and services to approximate demand, and should bring inflation to tolerable levels.

But until 1983, federal deficits could continue to pile up, inflation could continue at high levels, unemployment could increase, and interest rates could reach all-time highs. What if the American people find the cure worse than the disease over the short run and begin to express their disenchantment with the President's economic policies?

The Congressional elections of 1982 may provide the first measurable reading of the public's attitudes. If the

President's supporters in Congress can maintain, or even increase, their numbers, it could mean that Americans still share the administration's optimism that "supply-side" economics will eventually bail the United States out of its economic dilemma.

But if critics of "Reaganomics" make severe inroads in either house of Congress, it could well be a signal that the President's base of popular support is crumbling. It would strengthen the determination of Keynesian holdovers in Congress to resist further experimentation with the economic system.

If that were to happen, it could be one of the shortest economic "revolutions" in history—and probably one of the least productive.

But it also would leave Americans with an ominous, if not frightening, question. If the "old" economics was failing and leading us into national bankruptcy, and the "new" economics became too painful to endure for the prescribed period of recovery, what else can we do?

Somewhere out there may be a new Keynes or a new Laffer—an economic genius itching for the opportunity to test his own creative theories if the proposed solutions don't work.

But for now, "supply-siders" are firmly in the saddle in reshaping the nation's economic policies. If they prove to be right and economic conditions show the predictable recovery by 1983, they could remain in control for a long, long time.

After a half-century the age of Keynes would be over.

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